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SUBJECT: SRI LANKA: POWER SECTOR BADLY NEEDS REFORM,
BUT GOVERNMENT LACKS THE WILL

11. Summary: The state owned Ceylon Electricity Board (CEB) is the primary provider of electricity to Sri Lanka. The company is plagued with inefficiencies and a spiraling debt. Sri Lanka is dependent on petroleum products to produce 60 percent of its electricity. The price of production is sky rocketing as the price of crude oil has surpassed US \$140 per barrel. Despite having some of the highest prices of energy in the region, CEB continues to sell electricity below cost. CEB needs to diversify into less expensive sources of electricity to meet rising demand and bring down costs. The most promising options are coal and wind power along with an underwater transmission line that would allow India and Sri Lanka to share electricity. Although there is a general acceptance of need for change, powerful trade unions have prevented reform legislation from passing parliament. End summary.

ELECTRICITY GENERATION

12. Sri Lanka has only two utilities in the power sector, the state owned Ceylon Electricity Board (CEB) and the primarily state owned Lanka Electric Company (LECO). CEB serves approximately 90 percent of all consumer accounts and LECO the remaining 10 percent. All of LECO's consumers are located in the western coastal townships between Negombo and Galle.

13. In 2007, total installed power generation capacity was 2,443 MW. The two primary sources of electricity generation are thermal and hydro. Thermal made up 60 percent and hydro 40 percent of electricity generated. Most thermal electricity is produced by Independent Power Producers (IPPs) and sold to CEB, at unfavorable rates for the state owned enterprise, before being distributed to consumers. Thermal power is dependent on diesel and is one of the most expensive and inefficient ways to produce electricity. Costs are increasing rapidly as the price of fuel continues to rise. Thirty percent of all imported fuel is used to generate electricity.

While hydro power is generally more efficient than thermal power, it is limited by severe droughts. Sri Lanka has already developed almost all of its economically feasible hydropower potential. There are other sources of electricity, such as wind and solar power; however, currently their contributions are only marginal to the nation's power supply.

GROWING DEMAND

14. National electrification has improved drastically within the last two decades. In 1986 merely 10.9 percent of the population had access to electric grid; by 2005, 76.7 percent had access. The current level is significantly higher than other South Asian countries. The government has found it difficult to provide

electricity to many of the more remote and poorer villages. In 2002, the Eastern province Monaragala had one of the highest poverty rates at 32.4 percent and only 32.2 percent of households had electricity. The government also struggles to provide electricity to the northern region, which is largely controlled by the ethnic separatist Liberation Tigers of Tamil Eelam (LTTE). CEB continues to provide electricity to government-controlled Jaffna and the surrounding area using electricity not connected to the national grid, despite costs far outweighing revenue. While the current government has a stated goal to provide electricity to all who want it, CEB has set a target to provide electricity for 95 percent of all households by 2016.

¶5. Demand for electricity grew by an average of 6.7 percent from 1991-2000, slightly above the rate of GDP growth during the same period. Recently, demand for electricity decelerated because of increasing cost for tariffs. However, as the market adjusts to the new costs for energy demand is likely to return to a 7-8 percent growth rate. It is questionable whether CEB will be able to meet this demand. CEB has warned the public to cut unnecessary use of electricity and that the failure to reduce power consumption by at least 10 percent by July 2008 could cause disruptions of service.

NEW SOURCES OF PRODUCTION

¶6. Sri Lanka must look to new sources of energy to meet growing demand. Sri Lanka is counting on coal both to increase electricity production and to reduce costs. The first coal power plant is currently under construction in Norochcholai, funded by a Chinese government loan and built by a Chinese firm. The initial \$450

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million project is scheduled to add 300 MW to the national grid in 2011; the plan is to later expand this plant so it eventually generates 900 MW of power. Another coal power plant of 500 MW in Trincomalee that will be jointly owned by Indian and Sri Lankan firms is planned for 2013.

¶7. The Government of Sri Lanka (GSL) is relying on the private sector and development agencies to develop alternative sources of energy. Currently wind power is the only significant source of alternative energy, besides hydro, but only produces 3 MW of electricity annually. The government has issued 40 more permits for wind power projects that could potentially add 34 MW to the national grid; however, almost all of these projects have been delayed for lack of funding. The World Bank and other international organizations have funded projects that use wind, solar and hydro power off the national grid to provide electricity to areas where it was previously unavailable. Micro hydro plants are particularly well suited for Sri Lanka and are able to provide electricity to rural communities at affordable costs. In 2007 there were 5,869 households that received energy off the grid from a cumulative capacity 1,432 kW.

SRI LANKA-INDIA TRANSMISSION LINE

¶8. India and Sri Lanka are exploring the possibility of an undersea power transmission line between the two countries, as an alternative way for Sri Lanka to meet its energy demand. Such a link would enable Indian producers to sell their excess power to Sri Lanka at higher rates than in India. The link would also potentially enable Sri Lanka to sell power to India to meet the latter's peak demand periods. India has sent a draft proposal to the GSL for the two sides to split the cost of a \$3 million feasibility study on an underwater transmission line. The GSL hopes to sign the proposal by August. If the feasibility study goes well, the World Bank's International Development Agency has shown interest in funding the project.

EXPENSIVE TARIFFS

¶9. The GSL restricts how much CEB is allowed to charge and how often prices can be adjusted. In the past, CEB had been unable to

increase tariffs to offset rising capital and operational costs. In 2007, the average tariff was RS 10.56 per kWh (approximately \$0.10 per kWh), while the average cost to CEB was RS 14.79 per kWh. In order to curb further losses and to better reflect costs, in March of 2008 CEB increased prices by 40 percent. Despite the significant price hike, CEB is still losing an approximate average of RS 1.5 per kWh produced.

¶10. There is a complex system for determining tariffs. Prices for consumers are determined by the amount of energy used and are assessed both by fixed and per unit charges. There are separate price categories for different types of consumers. Generally prices are cheaper for domestic consumers and religious purposes and more expensive for businesses.

¶11. Despite tariffs in Sri Lanka not keeping up with costs, commercial and industrial tariffs were among the highest in South Asia in 2007. The price hike of March 2008 made tariffs even less competitive in comparison to other countries in the region. Observers worry high prices for electricity will deter investors, causing firms to look to other locations with more attractive rates.

DETERIORATING FINANCIAL SITUATION

¶12. CEB is in a financial crisis. In 2007 its operating losses equaled RS 21 billion (\$195 million). It had a total short term debt of RS 55 billion (\$510 million) and a long term debt of RS 89 billion (\$825 million) by end of 2007. CEB does not have a plan to reduce its debt in the foreseeable future and, as it is still losing money, its debt will only increase. Since CEB is a state owned enterprise, taxpayers will absorb the burden of this debt. The incentive for administrators to increase efficiency and ensure that CEB is solvent is diminished by the belief that the state and in turn the public will answer for their liabilities.

POWERFUL TRADE UNIONS PREVENT REFORM

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¶13. Powerful trade unions have blocked reforms that would improve the efficiency of CEB. Recently, the government attempted on two occasions to bring a bill to parliament that would break CEB into different sectors. Each time Marxist party-led unions, consisting of minor CEB staff, threatened to strike, forcing the bill to be tabled. The Asian Development Bank has offered a loan for power sector reform, but it is contingent on passage of this bill.

¶14. Ceylon Electricity Board Engineer's Union (CEBEU) is the most powerful union in CEB; it is the only union that could unilaterally create mass blackouts. The CEBEU has suggested some modifications to the proposed electricity bill, but does not have serious issues with it.

¶15. Despite the opposition's concern, it is unlikely that CEB will be privatized under the current administration. President Mahinda Rajapaksa promised on numerous occasions not to privatize CEB and that any reforms will need to be approved by all stake holders, including the unions.

COMMENT

¶16. The government needs to take bold action to ensure that production levels meet demand that is projected to grow by 7-8 percent in the coming years. The coal plant currently being built in Norochcholai and talks of a joint power transmission line are positive steps. Dependence on thermal power that uses fossil fuels must be reduced, in order to stem rising costs. In March 2008 the government increased electricity tariffs by 40 percent to better reflect the cost of production. While that was a positive sign that CEB is trying to stem its losses, the increased tariffs have added to what already were some of the highest prices for electricity in the region. This is likely to have a detrimental impact on investment and further inflation pressure. CEB needs to be

restructured in order to increase efficiency and the reform bill currently being debated in parliament would be a good start. The GSL has always had difficulty imposing reform against the wishes of intransigent unions, but now the primary obstacle to reform is the government itself, with its preference for large state run enterprises, however inefficient and unprofitable.